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What We Think……

FED UP!

Ever since rumours of the Fed's exit from QE surfaced in May, Fed Tapering has dominated the investment backdrop, globally. Investors have become fixated on every word spoken or written by Bernanke and the rest of the FOMC members, trying to deduce the Fed's next move. Yet with all the media coverage, expert analysis and most importantly "transparent communication" from the Fed, as investors we seem to be no further ahead in terms of our understanding and expectations of Fed Policy. Leading up to September's widely anticipated Fed meeting, surveys were indicating that at least 2/3rd of investors were expecting the Fed to begin tapering its QE program. We, as many others, were admittedly surprised that the Fed elected to continue its bond purchases unabated. In last month's and last quarter's commentaries we discussed the Fed at length, indicating our understanding of what we thought was a reasonably clear message from the Fed, and concluded that tapering was likely to start sooner rather than later. Consequently, many investors and commentators have become disillusioned with Fed communications; while some are just plain fed up with QE. Ultimately, the Fed's prerogative, if not obligation, is to change its mind if it deems it necessary – so called data dependency. That data dependency may be discordant with forward guidance is just another aspect of transparency and forward guidance that we are learning to deal with as investors.

So what should we expect from the Fed? We believe that the Fed elected to delay tapering principally because of concerns over the impending government shut down and the risk that initiating tapering would drive yields up by another 50 basis points and do irreparable damage to the consumer via higher mortgage rates and lower asset values. However, we still expect the Fed to begin tapering this year and cause longer term yields to move higher. Not surprisingly, following the Fed's recent inaction on QE at September's FOMC meeting, the market has undergone a retracement and yields have moved to, what we think is, a lower trading range: 2.5% to 2.75% for both 10-year Treasuries and Government of Canada bonds. We expect this range to hold until U.S. economic data pushes the Fed back into a telegraphed tapering mindset. However, we will continue to focus on the data; if there is anything that we have learned from the Fed it is, in this era of open-ended communication, to downplay the importance of the multiplicity of Fed comments. It should also be noted that Bernanke's tenure is most probably up and we will get a new fed chairperson, who will likely have a different approach to Fed messaging.

While the Fed's communication has seem garbled to us, it has been effective at introducing a level of uncertainty into asset valuations – almost certainly a goal of the Fed's tapering talk in the first place. The indecision surrounding asset purchases seems to have raised the floor on longer term bond yields, but more importantly established a floor on corporate yield spreads and a ceiling on equity prices. (The S&P 500 has not moved much beyond the highest level reached in May around 1650.) Despite the tapering of tapering talk, we don't expect to see the risk-on part of the risk-on/risk-off dynamic to be as stretched as we have seen over the last few years and, in particular, during the current round of QE. Further complicating matters is the broader macro picture including the US budget shutdown, European political and economic volatility and growing Middle East instability, which are all casting shadows over the U.S. economy.

So what should we expect from the data? In general, the path of economic data has not been all that unexpected to us. If anything, the greater surprise has been the Fed's reaction to the data and the impact and magnitude of capital market movements precipitated by the Fed's reaction and subsequent communication. Rate sensitive parts of the economy have been noticeably affected, in addition to bond, currency and emerging markets.

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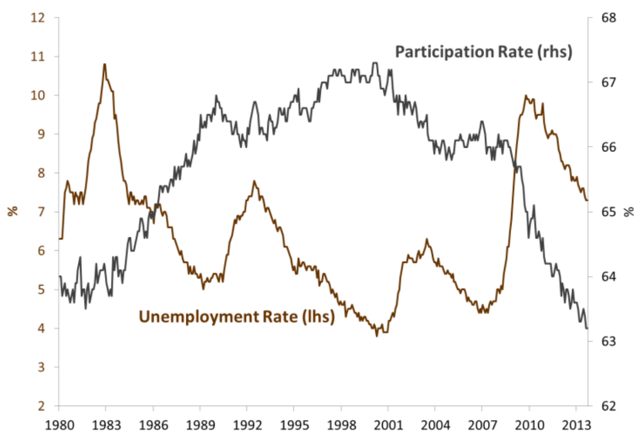
The unemployment rate has continued to tick lower, but so too has the participation rate (Figure 1). Combined, they don't describe an overly strong labour market, nor foretell a rapidly growing economy. In our view, they do suggest however, a tightening of slack in the labour market that reflect a dislocation of supply and demand of jobs and other longer term employment trends, rather than a simple case of discouraged unemployed workers. Without a significant hiccup in the economy, we expect the unemployment rate will continue to move gradually lower which will test the Fed's patience on how quickly it winds down its QE program. As far as inflation goes, we do think unemployment has room to decline before the Fed falls behind the curve. Elsewhere, we do not see material pressure on core prices.

Figure 1: Unemployment and Participation Rate



Source: BLS & Lorica Investment Counsel; as at September 2013.

The prospects for the economy remain solid, albeit not overwhelming. The housing market will be impacted by the recent rise in mortgage rates, but overall financing costs are still low and inventory light which should ensure a decent level of starts. Consumer spending will experience the biggest drag from higher rates, as translated through a reduction in refi activity (Figure 2), which will have an impact on labour markets as retail services have been a significant contributor to employment gains. US manufacturing activity has been volatile and should remain that way with only muted impact on employment and consumer spending.

Figure 2: US Mortgage Refi Activity

Source: MBA & Lorica Investment Counsel; as at September 2013.

Consumer confidence has shown steady improvement since the lows of 2009 and 2011, leading a steady decline of the unemployment rate (Figure 3). With the help of Fed stimulus, consumers have benefitted from lower borrowing costs and inflated asset values. In addition, up until recently, European financial problems and the US budgetary impasse had both faded into the backdrop. However, with the substantial rise of bond yields and the first US government shutdown in 19 years, consumers appear vulnerable to a loss of confidence. We anticipate that congress will eventually arrive at some compromise, but until then consumers as well as investors will be forced to deal with the uncertainty. Further complicating matters for investors will be the shutdown of government offices involved in compiling, calculating and disseminating economic and market data; though private data will continue to be available. In the absence of employment and inflation data, we expect markets to be somewhat less volatile than would otherwise be the case.

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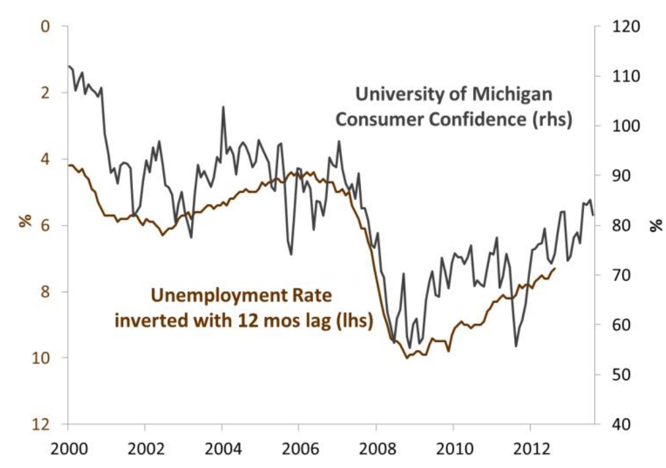
About 2/3rd of economist surveyed by Bloomberg believe that tapering will still take place this year, but given the current US government shutdown, October's Fed meeting is looking less likely as launching point for tapering. If budget and debt ceiling com-promises are reached, there will not be much standing in the way of the Fed, other than an unexpected poor prognosis for the economy. Assuming the government successfully bridges its divide, the yield curve should respond with some amount of steepening, with yields moving closer to the higher end of the current range. The risk is of course, no agreement on the budget and/or debt ceiling and a Fed that is definitively out of the picture until next year. In that event we could see longer-term yields fall and the yield curve flatten, although not to this year's lows. Canadian bond yields have generally tracked US bond yields, albeit with less volatility; we expect this to continue to be the case over the short to medium term.

Figure 3: US Unemployment & Consumer Confidence



Source: U.Michigan, BLS & Lorica Investment Counsel; as at August 2013.

Canadian Corporate Bonds

After several years of steadfast, but indirect support from the Fed, the corporate bond market now appears more vulnerable to the unpredictability of Fed policy. Corporate yield spreads are not narrow by historical standards and certainly not in relation to absolute yield levels, but there are important mitigating factors that handicap today's corporate market relative to previous periods. In addition, the principal factor that had been driving US spreads tighter – namely the Fed's asset purchases – can no longer be counted on to have the same impact going forward. Since May when tapering discussions first surfaced, corporate yield spreads have widened globally, with Canadian corporate bonds being strong performers, consistent with past episodes of yield spread widening (Figure 4).

Figure 4: US & Canada Corporate Yield Spreads

Source: Bank of America Merrill Lynch & Lorica Investment Counsel; as at September 2013.

Although corporate balance sheets are generally healthy and corporate bond defaults are historically low (Figure 5), a material amount of corporate bond demand has been stimulated by Fed quantitative easing. US Treasury issuance is still enormous by any historical comparison, but large amounts of Treasuries together with mortgage backed securities are being purchased by the Fed for their own balance sheet (Figure 6) as part of QE. These asset purchases have had the effect of crowding in US corporate bonds, which has had a ripple effect on corporate bond markets globally. Conversely, as investors anticipate a tapering of asset purchases, the predictable impact

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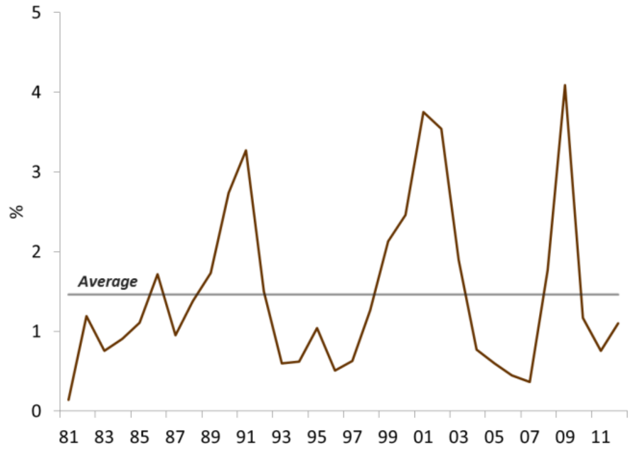
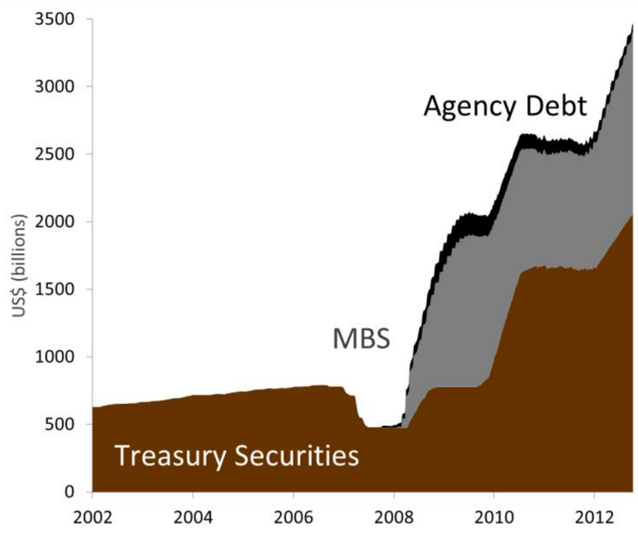
Figure 5: Global Corporate Bond Default Rate



Source: S&P & Lorica Investment Counsel; as at December 2012.

has been a reduction of investor demand for spread product. As we discussed in the previous piece section the Fed's communication has generated enormous confusion over the course of asset purchases which has translated into yield and yield spread volatility.

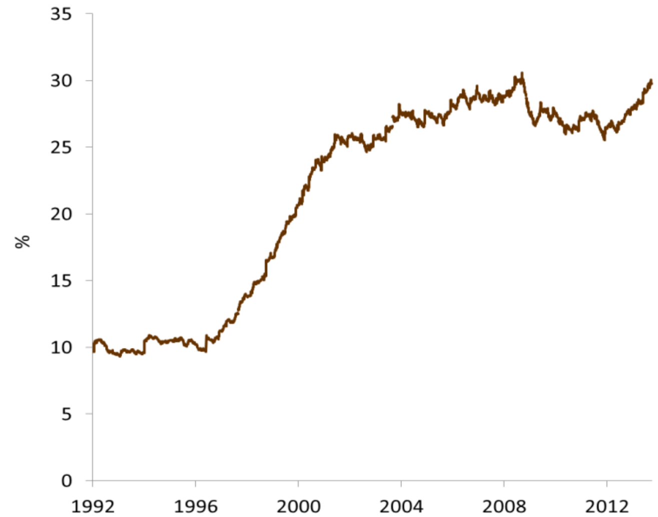
Figure 6: Assets Held By Federal Reserve



Source: FRB & Lorica Investment Counsel; as at September 2013.

During the 1990's there was a growth spurt in the Canadian corporate bond market as disintermediation of debt financing in the financial sector took hold – corporate bonds went from low teens to over 20% of the public bond market, according to the DEX Universe Index (Figure 7). Since 2000, corporate bond issuance has at least managed to keep pace with the growth of government debt (Canadas grew a cumulative 32% since 2000). However, following the credit crisis, when credit spreads ballooned to historic levels, corporate bond demand has been steady, despite the growth in government issuance. Flows have gone into corporate bonds for a variety of reasons including: more attractive yield spreads, investors reaching for extra yield over governments, reduction in over-weighted equity positions, ageing investors reducing equity exposure, and equity investors crossing over into corporate bonds. Most importantly, monetary policy encouraged the risk-on trade by making investors feel immune to higher yields and yield spreads. However, corporate demand has dropped off since May, with the emergence of taper talk, and yield spreads have subsequently widened.

Figure 7: DEX Universe Index Corporate Weight



Source: PC Bond & Lorica Investment Counsel; as at September 2013.

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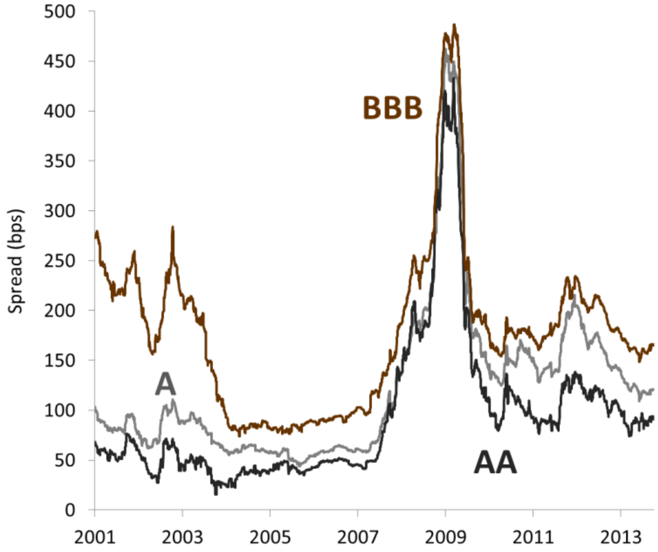
The relatively higher proportion of stable demand from pension funds and insurers in Canada than the US has ensured that Canadian corporate spreads have widened less.

Figure 8: Canadian Mid-Term Corporate Yield Spreads

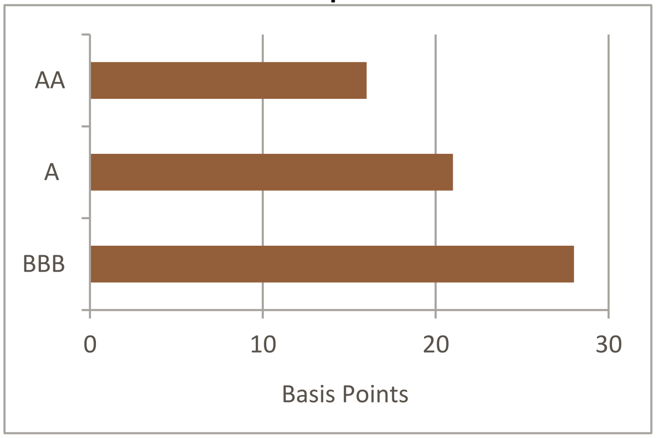


Source: PC Bond & Lorica Investment Counsel; September 2013.

Looking strictly at yield spreads, today's levels offer a reasonable amount of pick-up across credit tiers, with perhaps the higher-rated categories showing better value on a risk-adjusted basis (Figure 8). From the perspective of absolute yields, the relative pickup is certainly greater than what was available in prior periods of similar spread levels. But relative pick-up obscures the risk embedded in the yield spread which may be better thought of in terms of break-even's (or spread widening protection). However, we still believe that on a break-even basis, current yield spreads offer a reasonable amount of spread protection against spread widening. (Figure 9).

While we do not see huge risks for corporate bonds from an economic perspective, we also do not see a huge amount of support. Investors had been comfortable bidding up corporate bonds, both investment grade and high yield, over the last few years despite a variety of economic and market risks, because of supportive monetary policy which had stimulated both investor confidence and investment flow. We believe the Fed will not be able to conduct its asset purchases indefinitely and therefore investors will increasingly have to value corporate bonds in the context of low policy rates but without the effects of asset purchases. Higher bond yields have also caused a subtle exodus from corporate bonds of more opportunistic investors that had previously migrated to the corporate bond market to pick-up yield over government bonds or as a proxy for income equities. Many bond funds have experienced net redemptions since May and others have moved investments into cash or shorter duration assets. Further aggravating spread performance has been the liquidity in the secondary corporate bond market, which following the credit crisis has been greatly reduced. Corporate bonds have already undergone a slight revaluation, but the risk of further spread widening in response to actual Fed tapering is real.

Figure 9: Canadian Corporate Break-even Spread Protection – Mid-Term Corporates



Source: PC Bond & Lorica Investment Counsel; as at September 2013.